

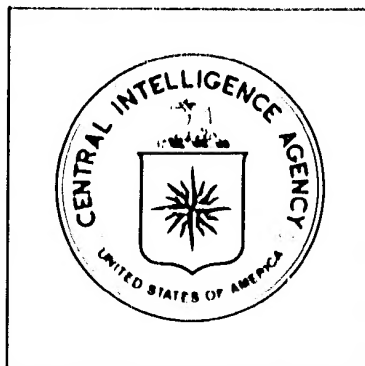
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88

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EAST ASIA

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CONTENTS

June 2, 1975

NORTH ASIA

	Pyongyang Makes Diplomatic Gains in East Asia.	i
25X6A	[REDACTED]	6
	The South Korean Economy.	9
25X6A	[REDACTED]	13

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Pyongyang Makes Diplomatic Gains in East Asia

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The collapse of non-communist governments in Indochina this spring has given new impetus to North Korea's campaign for improved diplomatic standing in East Asia.

Regimes sympathetic to North Korea were installed in Cambodia and South Vietnam in April. Thailand established full diplomatic relations with the North in May--largely to demonstrate that it is serious about improving relations with communist regimes while it sets about the more complicated task of establishing normal ties with the Indochinese communists and Peking. Also last month, Burma upgraded its consular relations with both North and South Korea to full diplomatic ties.

These gains continue a trend that began in mid-1973, when Pyongyang achieved a breakthrough among the generally pro - South Korean states of East Asia by establishing diplomatic relations with Malaysia--a leading proponent of neutralism in the Association of Southeast Asian Nations (ASEAN). (The other members are Thailand, Singapore, Indonesia, and the Philippines.) In another important breakthrough in 1974, North Korea established ties with Australia. Relations with Laos followed the same year.

It is also quite possible that North Korea will succeed in establishing diplomatic relations with two other ASEAN states--Singapore and the Philippines--later this year or early in 1976. Singapore already has consular relations with both Koreas, and the Philippines is being actively courted. President Marcos has been invited to visit Pyongyang, and a North Korean "ambassador" was received recently in Manila which, like

June 2, 1975

-1-

SECRET

SECRET

TABLEDiplomatic Relations of the "Two Koreas" in East Asia

<u>North Korea Only</u>	<u>Both North and South Korea</u>	<u>Neither North nor South Korea</u>	<u>South Korea Only</u>
China (1949)	Indonesia (1964)	Singapore	Japan
North Vietnam (1950)	Malaysia (1973)		Taiwan
Laos (1974)	Australia (1974)		New Zealand
South Vietnam** (1975)	Thailand (1975)		Philippines*
Cambodia** (1975)	Burma (1975)		

* Early possibility for North Korea

** PRG and GRUNK representatives are in Pyongyang, but North Korean embassies have not yet been established in Saigon or Phnom Penh.

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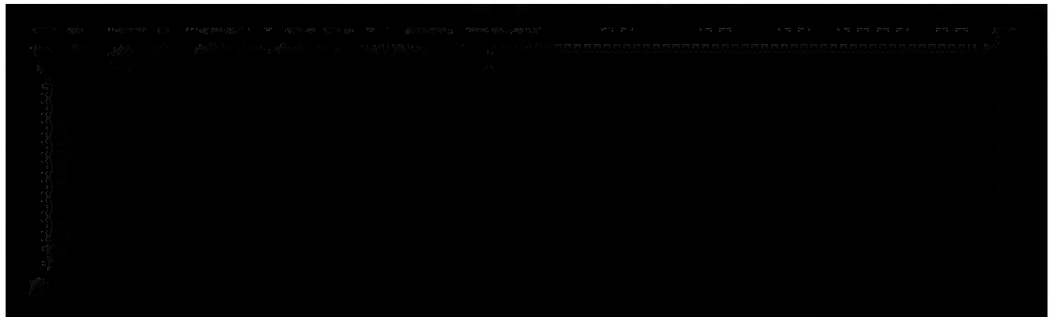
Bangkok, is increasingly interested in demonstrating a positive approach toward the Asian communist states. New Zealand officials have stated that they will delay normalizing ties with Pyongyang until tensions on the Korean Peninsula ease.

The North-South Competition

Between the Korean war and 1973, South Korea enjoyed major political advantages over North Korea in the East Asia region. Seoul had full diplomatic relations with ten non-communist states, while Pyongyang had ties with only China and North Vietnam--and with Indonesia, a holdover from the Sukarno period. Now, Pyongyang has relations with ten states and Seoul with only nine.

Seoul's policy of accepting dual recognition has permitted non-communist nations to retain relations with South Korea while establishing ties with the North. South Korean embassies have been closed down only in Laos, Cambodia, and South Vietnam. Ties have been maintained with Malaysia, Australia, Thailand, and--by virtue of an earlier arrangement--with Indonesia. In Burma, as noted earlier, the upgrading of relations with the two Koreas has been an even handed process. It appears certain, moreover, that Seoul will be able to retain ties with the Philippines, Singapore, and New Zealand if and when any of these governments move toward relations with Pyongyang.

25X6A



June 2, 1975

SECRET

25X6A

North Korea's diplomatic gains in East Asia are especially significant because Pyongyang has found it more difficult to break out of its post-Korean war diplomatic isolation in East Asia than in any other part of the world except Latin America. This was a result of the stigma attached to the North as the aggressor in the Korean war, a fact less easily forgotten in East Asia than elsewhere, and an image not at all dispelled by Pyongyang's intemperate behavior in the late 1960s. It was also a consequence of the region's strongly anti-communist cast during most of the Vietnam era.

North Korea's change of luck in 1973 and 1974 was in part a result of local developments; there were new and friendlier governments in Laos and Australia. In the case of Malaysia, however, it reflected the general softening of the regional anti-communist environment as US-China detente prospered and ideas of great-power balance in Asia gained regional adherents. North Korea contributed to the changed environment by its willingness to engage in peaceful (though so far sterile) dialogue with the South. Indeed, diplomatic gains were high on the list of Pyongyang's reasons for opening the North-South dialogue.

Significance

North Korea will derive important benefits from its improved standing among its neighbors--at the UN session this fall and at the conference of nonaligned nations in Lima in August.

At last year's General Assembly, backers of North Korea came within one vote of passing a resolution calling for an end to the UN Command in Korea

June 2, 1975

-4-

SECRET

and for withdrawal of US forces. But of all the East Asian countries, only China voted for the pro - North Korean resolution. This fall, Cambodia and Laos are almost certain to side with Pyongyang. Their votes, plus those of new friends the North has acquired in the Third World this year, will give Pyongyang a good chance of pushing its resolution through. Thailand and the Philippines--which backed South Korea strongly in the past--may now be inclined to remain in the background or even abstain.

Pyongyang's improved diplomatic standing with non-communist governments in East Asia will also help its cause at the Lima conference, which is shaping up as a caucus preparing Third World positions for the UN session this fall. North Korea will probably gain membership in the conference, despite Seoul's effort to block the move. Pyongyang's ties with such conference participants as Malaysia and Indonesia may be useful to its case.

The diplomatic gains are also reassuring to North Korea in terms of its broader competition with the South. In addition to better opportunities for regional trade, there is also less of a chance that one or more of the East Asian states might again react to a new war in Korea by rallying to the defense of the South. Thailand, the Philippines, Australia, and New Zealand did so in 1950, but this time around they more than likely would remain neutral, despite sympathy for Seoul.

The situation is not entirely adverse from Seoul's viewpoint. Regional diplomatic developments have helped ratify the "two Koreas" concept, the basis of Seoul's foreign policy since the early 1970s. There are now more than 40 states which recognize both North and South Korea--five in East Asia. (SECRET)

June 2, 1975

-5-

SECRET

25X6A

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Next 2 Page(s) In Document Exempt

Approved For Release 1999/09/26 : CIA-RDP86T00608R000300100001-8

The South Korean Economy
(x7884)

South Korea's economy has been hard hit by the worldwide economic slump. Although real growth last year averaged around 8 percent, all the gain came in the first half. The downturn has continued into 1975 when real growth will probably register only slight gains. Seoul will certainly be unable to achieve anything near its goal of 7 percent real growth this year because of continued weak demand in the major industrial countries that take the bulk of Korea's exports. The payments deficit, after bulging last year, will remain large in 1975.

Despite current economic problems, South Korea's long-term prospects remain good. The economy is structurally sound and has solid growth prospects once demand revives in the US and Japan, Korea's chief foreign markets. The country's low wage, skilled labor force, and broadening industrial base still makes it an attractive site for foreign investors. Given these positive attributes, Seoul is unlikely to alter its military or political thinking on the basis of current short-term economic conditions.

The Domestic Economy

Real output, after increasing sharply during the first half of 1974, stagnated in the second half. Although official data indicate some moderate production gains in the first quarter of this year, the improvement was well below Korea's normal growth pattern. Output in most major industries remains depressed, particularly in industries that export the bulk of their output. At the end of last year, output in the important textile industry, for example, was down 20 percent from the early 1974 peak. Plywood, electronics, and some heavy industries have also been hard hit.

June 2, 1975

- 9 -

SECRET

SECRET

The slump has pushed unemployment up substantially. At the end of 1974, official data, which tends to understate the situation, put employment at 5.6 percent. The trend toward layoffs and short hours continued in the early months of 1975. Employer groups and the government remain concerned over possible labor unrest although no serious incidents have occurred. Foreign-owned firms have faced some government pressures to maintain their labor force despite sagging output. A large number of local firms have gone bankrupt over the course of the slump, although most were small-sized operations.

Government Policies

Government policies are essentially aimed at bolstering employment and output. Stimulative measures that were initiated last November, however, are being tempered because of inflation and balance-of-payments problems. After shifting from a budget surplus to a large deficit, Seoul now is trying to pace its outlays to keep the fiscal stimulus within limits. Public works, welfare, and defense outlays nevertheless continue to rise. Seoul is also providing loans to firms to help avoid bankruptcies and to maintain employment.

Government policies have failed to slow the rate of inflation substantially. Consumer price increases have slowed only slightly, partly because of labor's effort to win catch-up wage hikes and the limited productivity gains achieved during the slump. For the past year, Seoul has attempted to influence price movements by maintaining controls on a variety of key commodities including electricity, as well as on consumer products such as cigarettes. Price controls have provided only temporary relief at best.

A key factor in the continuing inflation was Seoul's decision to permit a 17 percent devaluation

June 2, 1975

-10-

SECRET

SECRET

Approved For Release 1999/09/26 : CIA-RDP86T00608R000300100001-8

of the won last December. The currency adjustments, aimed at stimulating exports and damping import demand, resulted in a substantial increase in the domestic price for imported products. The urban population was affected most by the price hike because a large share of food supplies are imported. Seoul eased the impact on farmers by increasing subsidies for imported items such as fertilizers.

Trade and Payments

Seoul's most pressing economic problem is the deteriorating trade and payments position. The trade deficit last year jumped to \$1.7 billion, largely because of higher price for oil and other commodities. The current account deficit was \$1.8 billion, up from \$300 million in 1973. We estimate the current account deficit in 1975 will approximate \$2.4 billion, most of which will occur during the first half. Seoul hopes to reduce the second half deficit to only about \$800 million.

Underlying the payments problem this year has been a collapse in foreign demand for Korean goods. The decline began in mid-1974 and has been accelerating since then. Exports to Japan in early 1975, for example, were 40 percent below the year earlier. Sales to the US market have barely held their own. Imports, meanwhile, are running double the level of a year earlier. Seoul hopes to reduce the import bill substantially by tightening import controls and restricting foreign exchange available to purchase imports.

The trade imbalance has placed Seoul in a serious international financial bind. The deficit last year was financed with little difficulty through long-term capital inflows and a substantial increase in short-term foreign borrowing. By the start of 1975, however, financing the deficit required a large use of foreign exchange reserves. During the

June 2, 1975

-11-

SECRET

Approved For Release 1999/09/26 : CIA-RDP86T00608R000300100001-8

SECRET

first quarter of 1975, reserves declined by nearly \$200 million. By March, foreign exchange stringencies were more severe than at any time in the recent past.

Although the financing problem remains serious, we think Seoul will manage to squeeze by the next several months without having to dip deeply into its remaining foreign exchange reserves. The government will be able to draw funds from a number of sources including the balance of a \$200 million US bank loan and up to \$250 million from the IMF. Seoul will probably have at least some success in lining up funds from Japan and European sources as well as the World Bank. The largest single financial package may come from Saudi Arabia, which reportedly has tentatively agreed to provide loans of up to \$500 million. (CONFIDENTIAL)

June 2, 1975

-12-

SECRET

25X6A

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Next 5 Page(s) In Document Exempt

Approved For Release 1999/09/26 : CIA-RDP86T00608R000300100001-8